Rules, Enforcement, and Trade Liberalization: the Role of GATT

Considerable effort will be exerted during the Uruguay Round to devise rules to control better the use of various nontariff barriers to trade. New rules, however, require general acceptance of underlying principles. Disagreement among GATT members as to what those fundamental principles should be is a major stumbling block to improving GATT rules.

GATT's previous success in reducing tariffs was accomplished by developing a set of rules that discouraged increases in tariff rates, and then gradually reducing existing tariffs--on a most-favored-nation basis--through reciprocal bargaining during multilateral negotiations. The rules reinforced, but did not lead, the liberalization process.

A first step in liberalizing nontariff barriers will be to develop rules that clearly identify NTBs and demarcate those NTBs that are improper. Then the rules must be implemented. The Tokyo Round codes of conduct--a set of rules applying to several NTBs--relied primarily upon the good-faith compliance of signatories of the code. GATT enforcement procedures for the codes were cumbersome and ineffective. Although these codes may have restrained some governmental actions, there is little evidence that they have led to significant changes. The experience with tariffs suggests that reciprocal bargaining, involving coordinated concessions among trading partners at either the policy or the industry level, may be a more effective medium for liberalizing NTBs.

GATT dispute procedures play an important role in the trade liberalization process by encouraging countries to resolve their conflicts in an orderly manner without confrontations. Streamlining and enhancing the GATT dispute settlement process will be a major priority for the Uruguay Round. Establishing a nonpartisan standing panel of experts and applying stringent procedural deadlines can prove beneficial. But efforts to strengthen GATT's power to enforce its rules will encounter the reluctance of most governments to yield sovereignty over control of their national policies. It is unlikely that GATT will ever be the primary enforcer of its rules. Rather, in liberalizing NTBs, it will most likely rely on the adherence to mutually accepted standards of behavior by governments; its role will be to facilitate dispute settlements and other negotiations.

The Uruguay Round and Developing Countries

More vigorous participation by developing countries in the trade talks will require concessions by the United States and other developed countries in several ways. For example, developing countries want long-term guarantees of access to developed-country markets for their exports. Better access would involve loosening such barriers as the Multi-Fiber Agreement, along with promises by developed countries to refrain from erecting similar barriers in the future. This would force the developed countries to cede some of their existing markets to developing countries, and to adjust their domestic economies accordingly--involving difficult economic and political decisions.

Developing countries now have almost one-quarter of total world exports, and about one-eighth of world manufactured goods exports. Economic growth in developed countries is increasingly linked with the economic future of the developing countries. Yet most trade policy actions by developing countries are not regulated by GATT. Just as developing countries argue that it is not fair for developed countries to erect trade barriers that penalize them for their industrial success, so the developed countries complain of the self-serving trade policies employed by many of the most successful developing countries. Clearly, the advanced developing countries must be more fully integrated into the GATT system. The question is not so much whether this will happen as when and how it will be accomplished. Underlying the negotiations on many of the key issues in the Uruguay Round will be compromises over this graduation process.

Product and Country Trade Policy Discrimination

Countries increasingly resort to bilateral agreements, involving quotas and other nontariff arrangements, to solve trade disputes. Such agreements introduce two forms of trade policy discrimination: the application of policies unevenly across countries, and their application unevenly across industries. Although most forms of trade policy discrimination are discouraged by GATT, exceptions have always existed, and some observers question whether the principle of nondiscrimination will remain the basis for future trade agreements.

Most-Favored-Nation Treatment. Unconditional most-favored-nation (MFN) treatment--the application of a trade policy equally across all countries--is a cornerstone of GATT. Trade policies that discriminate by country not only complicate international trade relations and negotiations, but also may divert trade from low-cost producers to higher-cost producers. Such policies invariably induce countries not covered by an agreement to alter their behavior, often offsetting the original intent of the agreements and leading to further discord.

Violation of the MFN principle usually occurs for three reasons: a small group of countries may be able to work out an agreement more easily than a broader group (as in free trade agreements); a country aims specifically to penalize another country for what are perceived to be unfair trade practices (by retaliating against dumping, or applying countervailing duties in response to export subsidies); and a country places restrictions on imports causing injury to specific domestic interests. In certain of these situations, discriminatory practices may prove beneficial: free trade areas can create trade among the members; retaliation can force trading partners to halt unfair trading practices; and the selective application of trade remedies for the relief of threatened industries can limit the negative effects of suppressing competition. The danger, though, is that discriminatory practices may become the norm rather than the exception.

Specific Product Agreements. GATT does not explicitly require that protection be applied evenly across industries within an economy. But its general thrust is to limit the use of quantitative trade barriers--which are commonly used to provide higher levels of protection to some industries than to others--and to encourage reductions in trade barriers across all industries. Uneven protection that favors some industries relative to others can limit economic growth if low-productivity sectors are favored over higher-productivity sectors.

The case for special treatment of specific products is made on several grounds, namely: that temporary restraints provide an effective way of handling temporary market disruptions (as in autos); that specific exemptions are necessary to save the general rule of free trade, since without the ability to make exceptions the whole structure would fall; that different products have different characteristics, requiring somewhat different trading rules (as in textiles and various services); and, in the extreme, that some products (as in the steel, agriculture, and high-technology industries) are so vital to national interests that administrative solutions are preferable to market results.

Alternatively, it can be argued that most restraints to trade are detrimental to world economic growth, and often to the countries enforcing the restraints. It can also be argued that the proliferation of sectoral protection and managed-market agreements breeds more protection, as it becomes difficult to justify protection for some sectors and not for all.

The Uruguay Round will specifically address the most serious case of sectoral discrimination--that in the agricultural sector. It will also take up other specific sectoral actions, including barriers to trade in services, the

Multifiber Agreement and other voluntary export restraints in various industries, and the "safeguard" procedures that are used to implement many of these policies. The United States has been an active user of discriminatory trade policies, and the results of these trade talks may limit the flexibility of U.S. trade policy in the future.

IS GATT WORTH SAVING?

The strongest defense of GATT is based more on what it has prevented rather than on its explicit accomplishments. Since the creation of GATT, world economic growth has not been fettered by nationalistic policies. Instead, it has been stimulated by expanding international trade.

GATT was created primarily to reduce the possibility of another debilitating trade war similar to that which followed the Smoot-Hawley Tariffs at the beginning of the depression. It was also intended to undo much of the damage caused by those actions. By this test, GATT can be judged quite successful. Although trade relations have suffered numerous crises over the last 40 years, these have not set back world economic growth. And GATT-sponsored multilateral negotiations have helped to reduce the Smoot-Hawley-era tariffs by over 90 percent: the average tariff rate for most developed countries is now less than 5 percent.

The value of GATT lies not only in its rules, but in the fact that it also provides a forum where countries can resolve disputes over national policies. GATT is one of the few policy forums where long-run goals guide the resolution of short-term crises. No comparable framework exists for settling other key international problems--such as how to coordinate macroeconomic policies or to lighten the burden of debt.

GATT needs to be modernized, however, and this means rethinking the principles that should guide trade policy for the rest of the century. GATT has little independent power; it merely reflects the will of its members. To revitalize it, the members will need to reexamine many long-standing domestic policies and reassess their national priorities, given increasingly important economic linkages among countries. The problem is not the inadequacy of GATT, but rather how governments are going to mesh their policies with the requirements of the world economy. Opening up the potential of international trade represents one of the great challenges facing governments today.

CHAPTER I

INTRODUCTION

Over 90 countries joined together to launch the Uruguay Round of multilateral trade negotiations during a meeting of trade ministers in Punta del Este, Uruguay, last September. The Uruguay Round is the eighth sponsored by the General Agreement on Tariffs and Trade (GATT). It continues the process of adapting the GATT framework of trade agreements to ever-changing international economic conditions. Formal negotiations to determine the procedural format for the talks have already begun, and a four-year deadline has been set to complete the talks.

The United States has led the drive for new multilateral trade negotiations. Other governments have joined in--some enthusiastically, some reluctantly. Although the United States has been the prime motivator for trade liberalization since World War II, the intensity of its push for a new round reflects concerns about the economic and political ramifications of recent record trade deficits. Even though the U.S. trade deficits are primarily a response to macroeconomic policies, certain U.S. industries have suffered heavily from foreign competition. [1/] The result has been political pressure to redress the balance by establishing quotas or tariffs on certain imports as well as by taking aggressive actions to reduce foreign barriers to U.S. exports. Other countries have responded by pointing to the protective trade policies of the United States. Some that are reluctant to enter a new round of trade negotiations have done so rather than face the prospect of a retaliatory trade war with this country.

Negotiators in the Uruguay Round will focus on extending the GATT framework in two dimensions: to goods and services that are now not included, and--perhaps more crucially--to nontariff barriers to trade (that is, the broad range of nontariff national policies that have sizable impact on international trade). Priority will be given to the following agenda: liberal-

1. For a clear analysis of the relationship between trade policy and the aggregate trade deficit see Rachel McCulloch and J. David Richardson, "U.S. Trade and the Dollar: Evaluating Current Policy Options," in *Current U.S. Trade Policy: Analysis, Agenda, and Administration*, Robert E. Baldwin and J. David Richardson, eds., National Bureau of Economic Research Conference Report (1985).

izing both tariff and nontariff barriers to trade in agricultural products, in tropical and natural resource products, in textiles and apparel, in steel, and in services; strengthening GATT rules and enforcement procedures, especially those related to subsidies; establishing GATT rules to protect intellectual property rights; and standardizing safeguard (escape clause) procedures across countries. Since many of these issues deal specifically with policies employed by developing countries, expanding the GATT framework in this way will force a reassessment of the role of developing countries' policies in the world trading system. And given the importance of international trade as a stimulus to economic growth, the results of these talks will help shape U.S. and worldwide economic prospects throughout the rest of this century. [2] They may also affect the federal government's economic and budget policies for many years to come.

WHAT IS AT STAKE?

The Uruguay Round comes at a time when governments are increasingly intervening in world trade to try to manage world markets for key products: in some cases allotting national market shares and inhibiting competition; and in other cases aggressively pursuing policies to enhance the competitiveness of particular industries. Many recent government actions--especially in the form of export subsidies, voluntary export restraints and other nontariff barriers to imports, and bilateral agreements--contradict the GATT principles that have successfully supervised international commerce since World War II. As government intervention increases worldwide, additional protective measures become more easily justifiable, especially for defensive purposes. Such a spiral of trade restraints could jeopardize world economic growth and the welfare of nations.

Benefits of Free Trade

Economists have long extolled the benefits of free trade. Free trade is a positive-sum activity--those who trade do so because of mutual benefit.

2. A number of books and articles have been written recently that deal with the Uruguay Round of trade talks. Three that have been useful for the preparation of this report and which are not specifically quoted in the text are: Michael Aho and Jonathan Aronson, *Trade Talks; America Better Listen!* (New York: Council on Foreign Relations, 1985); Gary Hufbauer and Jeffrey Schott, *Trading for Growth: The Next Round of Trade Negotiations* (Washington, D.C.: Institute for International Economics, 1985); and William Cline, ed., *Trade Policy in the 1980s* (Washington, D.C.: Institute for International Economics, 1983).

Free trade expands the range of products available for consumption; broadens the markets for a country's producers; and increases a country's productivity by encouraging greater specialization.

International trade can be a stimulus to economic growth in both developed and developing countries. While larger countries can sometimes grow for a time by exploiting their own internal economic diversity and market size, as a rule a country cannot maintain high domestic economic growth rates for long without increasing its foreign trade. The importance of trade can be seen in the fact that the total volume of international trade increased by 1.6 percent for every 1 percent increase in world economic growth over the high-growth period 1950 to 1973. As worldwide economic growth began to stagnate in the period 1973 to 1984, this ratio fell to 1.1 percent. [3]

Foreign trade has played an increasing part in the U.S. economy over the last 20 years. The ratio of imports or exports to total output (GNP) has almost doubled over the last two decades. Sectors such as agriculture, electronics, aircraft, certain types of machinery, and chemicals rely heavily on foreign markets for sales, while many domestic producers and consumers gain from the purchase of imports.

Difficulties with Free Trade

The strong argument for free trade summarized above ignores the fact that free trade raises serious problems for governments. First, although free trade improves the overall standard of living in a country, the benefits are not distributed equally. The benefits are received by the most competitive productive groups, who are often already relatively well off, while the costs are borne by the least competitive groups. While gains to consumers more than outweigh losses to producers, their gains are normally spread thinly among many buyers. Moreover, if the shift of resources toward the more competitive sectors leads to unemployment during the adjustment process (and individual firms and workers lose some capital or skills specific to their former employment), then the private loss for some groups in the economy may be considerable. Unemployment introduces some social loss to the economy as a whole. Rather than attempting to compensate the losers by drawing upon the benefits of trade, governments often try to protect these weaker segments of the economy from foreign competitors at a net cost to the economy as a whole. Such protection generally forces consumers to pay

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3. Annual Report of the General Agreement on Tariffs and Trade, 1984/85, p. 18.

higher prices, and retards structural changes in the economy that can lead to higher productivity over time.[4] There may be much less costly and more equitable ways to achieve these distributional goals than using trade policies.

Another problem arises when one country uses trade policies to gain advantage at the expense of its trading partners.[5] Beggar-thy-neighbor policies can succeed if other countries do not retaliate. Retaliatory trade wars reduce the overall standard of living of all countries involved. A better course is to try to modify the unfair trading policies of other countries through negotiation rather than by retaliatory measures.

Government's Role in "Competitiveness". A new development in trade policy is the recognition that governments can fabricate comparative advantage. The traditional economic model explained trade flows between countries as the result of differences in resource endowments. But an increasing proportion of world trade now consists of the exchange of similar products between countries with comparable resource endowments and production technology. Success in this "intra-industry" trade relies more on such factors as economies of scale, business acumen, research and development, and product innovation than on differences in wages and capital stock. Maintaining market share becomes essential for the long-run viability of this type of trade. Since the margin of competitiveness is so narrow, traditional government policies such as education, scientific and research grants, and credit allocation can tip international competitiveness in favor of one country's producers against another's. The use of active government policy as a fundamental determinant of dynamic comparative advantage muddles the concept of "fair" trade policies. Just how far governments may or should go to support their nations' industries is an important question underlying many of the topics that will be discussed during these negotiations.

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4. Instead of protecting industries from foreign competition, government can try to assist them in adjusting to changes in demand. Theoretically, adjustment programs lower many of the costs related to changes in trade flows, but such efforts in practice have met with mixed success. The economics of the adjustment process are obscure. For example, the many factors that influence a family's decision to change jobs or move to another region have not been adequately modeled. In fact, there is a shortage of information on even the magnitude of the problem. The most thorough examination of labor displacement is: U.S. Congress, Office of Technology Assessment, *Technology and Structural Unemployment: Reemploying Displaced Adults*, OTA-ITE-250 (February 1986).

5. Under certain conditions, optimal tariffs and other trade policies can be used to increase the welfare of one country relative to its trading partners, but the loss in welfare to its trading partners exceeds the gain to the country.

THE NEGOTIATING ENVIRONMENT

Multilateral negotiations allow countries to develop a common framework for approaching trade problems and afford the opportunity for reciprocal bargains that can make all parties better off. But negotiations often take several years, and outcomes are generally phased in over time. Multilateral talks rarely solve immediate trade conflicts.[6] Instead, negotiations develop an enduring set of guidelines that moderate trade policy responses to various economic and political pressures, while gradually reducing restrictive trade policies already in place. GATT rules operate in a fashion similar to domestic laws that regulate social relationships. During periods of well being, GATT maintains a low profile and its negotiations encourage steady, but rarely dramatic, trade policy reform. During periods of economic stress, as is the case now, the GATT framework works to restrain governments from employing policies that they may later regret.

Previous rounds have induced developed countries to reduce dramatically tariffs on most manufactured goods imports: the average tariff rate on dutiable imports into developed countries is now around 5 percent, compared with much higher average tariff rates (almost 60 percent for the United States) when tariff liberalization talks first began in the early 1930s. The negotiations, especially the most recent Tokyo Round, have also begun the process of controlling the spread of nontariff barriers.

But a large proportion of international trade is still encumbered by various governmental policies. Many kinds of nontariff barriers have been erected that are not effectively controlled by GATT rules. These barriers are especially high in agriculture and in services. Even where GATT discipline is well established (for example, GATT rules designed to discourage dumping of manufactured products such as semiconductors), member governments have been increasingly unable to resolve their differences.

The broad task facing participants in the Uruguay Round, therefore, is to modernize the GATT framework of rules and procedures to cope better with the new realities of international trade, and to use these rules to achieve more liberal policies. This involves strengthening GATT authority where it already exists, and establishing GATT rules and enforcement pro-

6. A major effort of the Uruguay Round, as discussed more fully in Chapter II, will be to enhance GATT's institutional ability to handle day-to-day trade disputes.

cedures for trade in nonmanufactured goods, for trade with developing countries, and for many nontariff trade barriers, none of which are now covered adequately by GATT. Better rules, though, must be implemented to be effective. Although previous rounds produced rules to govern the use of several nontariff barriers, compliance with them relied mainly on the good faith of members. GATT enforcement procedures are passive and weak. There is little evidence that these procedures have significantly liberalized trade. One specific task, therefore, will be to strengthen GATT's powers to enforce compliance. If experience with tariff reduction is a reliable guide, however, governments will be most likely to reduce trade barriers when a tangible concession by one country can be roughly offset by a reciprocal concession from a trading partner.

Negotiating Procedures

Deliberations leading to the Punta del Este Declaration and the initial talks in Geneva have been dominated by jockeying to establish favorable positions for the start of the substantive negotiations. Partly as a compromise to achieve the broadest possible agenda, the Punta del Este agreement assigned most of the major items on the agenda to separate working groups.[7] Although the mandate for many of these groups stresses rule-making and enforcement procedures, concessional bargaining to liberalize existing policies may occur in a number of cases. Negotiations in most groups, at least initially, are to be self-contained, thus limiting demands for reciprocal concessions across groups. This arrangement, by impeding cross-issue reciprocity, means that there will be less incentive to compromise, and thus less likelihood of major concessions on some key issues (see box). Activities in each group will be coordinated by a Trade Negotiations Committee consisting of representatives from various participating governments. How reciprocity is to be measured for a final agreement involving the many issues on the agenda has yet to be determined.

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7. All decisions in GATT must be approved by consensus. As more countries with diverse interests participate in GATT activities, consensus forces administration by compromise. To obtain the approval of several key developing countries to the Punta del Este Declaration, developed countries agreed to separate negotiations on services and manufactures trade. The developing countries demanded this in order to weaken any reciprocity link between increased access by developing countries to manufactured product markets in developed countries and reductions in trade barriers for service trade by developing countries.

RECIPROCITY IN GATT NEGOTIATIONS

A hallmark of GATT negotiations is that each country enters voluntarily with the prospect that nothing must be yielded unless matched by reciprocal actions from its trading partners. Generally, each major negotiating team tries to achieve a roughly equivalent level of multilateral reciprocity in any final agreement, ensuring that each country can claim success when the deal is brought home. Designing a scoring method that tallies reciprocity across thousands of tariff classifications and numerous nontariff issues while remaining agreeable to the many negotiating parties is not a simple matter. Different measures of reciprocity may favor different countries. GATT does not specify how reciprocity is to be measured. Rather, the terms of reciprocity are an integral part of each negotiation process.

During the early rounds, when tariff reductions dominated the agenda, multilateral reciprocity was measured by the value of trade covered by tariff concessions, which were made on a most-favored-nation basis. In recent rounds, the average depth of tariff cut also was employed to measure reciprocity. The ultimate, but far too complex, criterion of equalizing gains in national welfare was at best indirectly relevant. By the Tokyo Round, data became available that allowed some countries to use economic models to estimate the effect of tariff concessions on trade flows, domestic output and employment, and economic welfare. More sophisticated reciprocity criteria, especially some allowing the summation of national benefits and costs over numerous nontariff agreements, may be used by many countries during the Uruguay Round.

Multilateral reciprocity was not used during the Tokyo Round negotiations concerning codes of conduct for nontariff barriers. Instead, reciprocity was defined independently for each code. Code reciprocity allowed a country to choose whether to sign a code without prejudicing its bargaining power in other parts of the negotiation. Limiting cross-issue reciprocity in this way made it easier for like-minded groups to enter into agreements. But it introduced two problems. Since the agreement required that signatories apply the discipline of the code only to trade with other signatories, it could potentially breach the principle of nondiscriminatory treatment, which has been a cornerstone of GATT. Also, parties often have unbalanced demands. One country may have little to gain by reciprocally reforming policies in one particular issue, but much to gain from concessions on another issue. By limiting trade-offs between issues, considerable bargaining leverage is wasted.

As in previous rounds, each country accepts a "standstill and rollback commitment." This commits negotiating governments not to initiate any new trade polices inconsistent with GATT rules over the course of the talks and to phase out by the end of the talks any trade policies currently in place that are not consistent with GATT rules. The purpose of the standstill commitment is to provide some order to the negotiations by stopping a country from altering its trade policies so as to enhance its bargaining power. In past rounds, however, both commitments served more as statements of intent than enforceable promises. Various countries introduced new protection during the Tokyo Round--the U.S. trigger price policy for steel, for example--and any policy rollback occurred as a result of reciprocal bargaining.

The Economic and Political Environment

Trade issues are always politically sensitive, especially during periods of economic stress. Economic performance in one country is increasingly linked through international trade and monetary flows to activity in other economies. These linkages have recently been under great strain, as witnessed by large swings in exchange rates, prolonged weakness in world commodity markets, huge trade account imbalances, and the developing-country debt problem. World economic growth has been moderate at best over the last several years, and seems likely to continue that way.

Macroeconomic Policies and International Markets. Most of the instability in international markets can be explained by divergent macroeconomic policies in the United States, Japan, and the European countries. [8] During the early 1980s, emphasis shifted abruptly toward deflationary monetary policies, as key central banks refused to accommodate the second round of oil price increases. Generally weak economic growth ensued. World commodity prices plummeted, precipitating a crisis for many developing countries that had borrowed heavily and that depended on commodity exports. At the same time, U.S. fiscal policies produced record federal budget deficits, and key foreign governments moderated their fiscal deficits. Together, these trends contributed to a substantial appreciation of the dollar and a massive increase in the U.S. merchandise trade deficit (see box). Although recent changes in macroeconomic policies have reversed these trends to some degree, the world economy is still faced with huge trade imbalances and prospects in most countries for no better than moderate growth.

8. See Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1986-1990* (February 1985).

Foreign governments face the counterpart of the massive U.S. trade deficit problem. Many of them have relied on large trade surpluses with the United States to bolster their economies. High rates of unemployment exist throughout Europe. The rapidly growing Asian developing countries depend on trade surpluses with the United States, as do many debt-ridden Latin American countries. Japan, despite its enormous U.S. trade surplus, has lost its formerly high growth rate and is encountering problems characteristic of a mature economy. Improvement in the U.S. trade balance will therefore require a process of adjustment on the part of other countries, and the stresses of this adjustment will complicate bargaining positions in the Uruguay Round over the next several years.

Fundamental Shifts in Industrial Competitiveness. The industrial world has undergone far-reaching changes over the last several decades. Dramatic reductions in natural barriers to trade, such as communication and transportation costs, and the emergence of developing countries as competitive producers have increased the pace of international specialization. Many products from maturing and standardized industries in developed countries can be produced more cheaply in low-wage developing countries. Lower costs from large-scale production facilities encourage specialization even among developed countries, as in the case of high-technology products.

The resulting changes in trade flows have forced many economies to undergo major restructuring. Some workers, firms, and communities have improved their economic positions; others have lost. In almost all cases, though, there have been political repercussions.

Governments can seek to alter the situation with short-run policy responses, either unilaterally or through agreements with other countries. But such limited actions frequently do not resolve the causes of the root problem, and often create new problems with third countries or in other domestic sectors. [9] Multilateral negotiations can take account more directly of the many interactions between different countries and different economic sectors that are inherent in the application of trade policies. But as more parties participate in the negotiations, a wider range of interests must be satisfied. The reciprocal concessions involved in multilateral negotiations may cause additional dislocation in some sectors of each economy.

9. See Congressional Budget Office, *Has Trade Protection Revitalized Domestic Industries?* (November 1986).

THE U.S. TRADE AND BUDGET DEFICITS

The record foreign trade deficits experienced by the United States have focused attention on what causes them and how they can best be reduced. There have been proposals to use trade policy to change the export-import balance, or alternatively to try to negotiate a solution during the Uruguay Round.

Trade policy has had little to do with the emergence of the huge trade deficits, and it cannot be expected to reduce them significantly. Governments can effectively use trade policy to alter the composition of imports and exports by favoring certain industries at the expense of other industries. But the large aggregate trade deficits were caused primarily by macroeconomic conditions, and can be substantially curtailed only by changing those conditions.

International trade at the product level depends primarily on the relative price of a domestic product relative to similar foreign products and the real income of potential consumers. When the price of a good falls relative to those of close substitutes, or when real income increases, the demand for that product increases. Demand for traded goods and services depends both on industry-specific factors, such as changes in technology or the use of trade policies, and on economywide factors, such as exchange rates and differences in inflation and real income growth among countries, including those disruptions caused by the developing-country debt crisis. Confusion sets in when the determinants of foreign trade at the product level are used to explain net trade flows between countries.

The foreign accounts of an economy are directly linked to its saving and investment relationships with other countries. These relationships can be characterized by three sets of ratios, each defined relative to GNP: domestic and foreign private saving as ratios of GNP in each country; domestic and foreign private investment as ratios of GNP in each country; and domestic and foreign government budget deficits as ratios of GNP. When these ratios diverge among countries, domestic or international forces must respond to bring the relationships underlying them back into equilibrium. Trade policy can affect the aggregate trade balance only if it can affect these macroeconomic constraints--that is, only if it can alter the net capital flow into an economy.

Each of the three macroeconomic constraint ratios may change in response to various economic forces. Recent years have seen a dramatic increase in the U.S. government budget deficit ratio coupled with significant, although less dramatic, declines in many foreign government budget deficit ratios. The large U.S. government deficits expanded U.S. demand for investment funds (savings) at the same time as many foreign governments were creating new excess supplies of savings by reducing their

THE U.S. TRADE AND BUDGET DEFICITS

deficits. In a closed economy, excess domestic demand for savings would cause interest rates to rise, crowding out some domestic investment and encouraging new savings (and less consumption) until a new balance would be achieved. But in the current environment, where international financial transactions costs are negligible and exchange rates are flexible, the excess demand for savings in the United States attracted massive net inflows of financial capital from abroad, tempering any increase in U.S. interest rates. The increase in demand for dollars as foreigners purchased dollar-denominated assets raised the value of the dollar, causing the prices of U.S. goods and services to increase relative to foreign goods and services. To satisfy the balance of payments constraint, the exchange rate had to increase by enough to force the U.S. trade (current account) deficit to equal the net capital inflow from abroad. In essence, access to international markets shifted the domestic adjustment burden of the U.S. budget deficits away from interest-sensitive segments of the economy to traded-goods segments.

Government budget deficits are not the only cause of trade deficits. Divergences in private savings and private investment ratios across countries can also induce changes in international trade and capital flows. U.S. calls for more vigorous foreign growth are aimed at raising foreign private investment, which would both sop up foreign savings and increase foreign demand for U.S. goods and services. A major objective of the effort to relieve the developing-country debt crisis is to reduce pressure on the U.S. trade balance. The debt crisis, manifested mostly in Latin America, has forced these countries to limit imports severely, and to expand exports, in order to service their foreign debts. Private investment ratios in these countries have fallen, causing economic growth to deteriorate. The economic disruption associated with the debt crisis has been aggravated by significant private capital outflows from many of these countries, forcing them to produce even higher merchandise trade surpluses. Since the United States is the major trading and financial partner for most of the debt-constrained countries, the debt crisis has been a major contributor to the U.S. merchandise trade deficit.

Recognition of the myriad factors affecting international trade and capital flows has led some to call for expanding the scope of international economic cooperation by conducting parallel negotiations that would seek to coordinate macroeconomic policies, and thus stabilize exchange rates; remedy the debt crisis; and improve the conduct of trade policy. Such coordinated actions face formidable obstacles. Although GATT trade talks play a vital role in providing conditions that are conducive to expanding international trade and economic growth over time, they cannot be expected to offer a solution to the current U.S. trade deficit crisis.

THE URUGUAY ROUND AND THE CONGRESS

The nature of the new trade talks raises a number of important issues for the Congress. Most immediately, Congressional authority for the President to negotiate tariff reductions expired in 1982 and authority for nontariff barrier negotiations, with an expedited approval procedure, expires in January 1988. The bills now before the Congress would extend the President's negotiating authority. Such an extension will be necessary before a Uruguay Round agreement is completed. In the past, the Congress has provided the President with authority to reduce tariffs up to a specified amount over a fixed period of time without further Congressional approval. Authorizing bills have also indicated the priorities of the Congress for the negotiations. The Congress has always retained the right of final review for nontariff agreements, but does so on a fast-track basis--meaning that no amendments are allowed, and that a final vote on all the provisions as a package must be conducted within 90 days of submission.[10] Since the actual negotiating process is largely controlled by the Administration, and since subsequent changes are limited by the fast-track procedure, the authorizing bill will represent an important opportunity for the Congress to influence the outcome of the Uruguay Round.

Because the Uruguay Round will focus more than ever before on the impact of broad national policies on foreign trade, the final agreements reached during the talks may require changes in these national policies and may limit future Congressional policy options. For example, any major reform in Eurpoean agricultural policies is likely to involve a demand for reciprocal reforms in U.S. farm policies. Reductions in barriers to services trade by foreign governments may require lower U.S. protection for manufactured goods such as apparel and steel; or they may require the United States to change immigration laws or reorder traditional state and federal responsibilities over the regulation of some services. Agreements limiting the subsidizing or "targeting" of industries may impede science and competitiveness policies; Sematech, the proposed consortium of semiconductor producers, for example, may be jeopardized by such an agreement. In any event, closer attention will be paid to the foreign-trade ramifications of national policies, both in the United States and abroad.

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10. The crafting of a final GATT agreement involves a series of compromises between countries toward reaching an acceptable level of final reciprocity. In order to limit the unraveling of this process, fast-track authority prevents the Congress from changing the specifics of any part of the agreement.